

# Moderating Loss Cycle?

- **Credit Loss Expectations May Be Too High**
- **Supported By Both the Sharp Decline in Deferrals & Recent Discussions with Bank CEOs**
- **Other Major Hurdles Remain But the “Wild Card” on Losses is Becoming Less Wild**

We have been assuming a significant, COVID-related loan loss cycle for banks, with the first, probable uptick beginning in the current quarter. After “channel checking” with bank CEOs around the country we find little anecdotal evidence of immediate losses and compelling evidence for a more favorable future loss outlook. If true, there are two positive implications, higher stock prices and M&A, the latter becoming less contingent on credit. Credit risk will become less of a hurdle during merger discussions. Easing M&A is the bigger positive if we are on the right path for credit.

Our original projection based on a regression analysis of six macro variables across six separate categories of credit indicated a 630 basis point cumulative loss from the pandemic and the subsequent closing of the economy. This was estimated over six quarters or roughly 420 basis points per annum. The Federal Reserve’s Spring DFAST had a range of 820 to 1030 basis points accumulating over nine quarters of an economic recovery ranging from a “V” to a “U” or roughly 410 basis points per annum at the midpoint of their range. The fact that the Fed came up with virtually the same loss estimate as ours added conviction at the time.

It seems logical that for something of this magnitude a tip-of-the-iceberg upsurge in charge offs should become evident during the second half of this year. If so, we are finding little anecdotal support for this in the third quarter, other than in select verticals such as travel, senior living, and energy.

While it is certainly premature to suggest credit is back in its box, it is nonetheless not as wild a wild card as it presented a few months ago. No victory being declared here, and there are several other hurdles and negatives facing the industry outside of credit including the pandemic itself, the election, slowing economic momentum and the unfavorable interest rate environment.

To be sure, there are possibly only temporary reasons for the brighter credit outlook. The unemployment package has been extended for six weeks albeit at half the previous amount. The PPP program could have prevented immediate damage to small and mid-sized businesses that will now season without further help and expose weakened business models. Expectations for another round of “stimulus” could prove false. And another round of COVID infections would add cumulative stress to both personal incomes and businesses in general. However, it is doubtful that another severe economic lockdown would be imposed.

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Banks have had time and motivation to examine portfolio risk fairly granularly and have found little likelihood of charge offs for now, except in very direct COVID related sector exposure. It is also quite possible the latent risk in portfolios is below the granularity examined, meaning commercial loans to smaller companies could still experience a wave of losses.

Second, deferrals have been dramatically melting during the current quarter. Many banks are now disclosing their level of deferrals at mid-quarter. Deferrals were averaging about 12+% of loans at the beginning of the quarter but have now fallen into low single digits. Deferrals are not comparably quantified as some banks would only defer principal, and it is possible that interest and principal accommodations have been made under certain circumstances. The only thing clear is that the current level includes some second-round deferral actions. But the overall drop has been impressive.

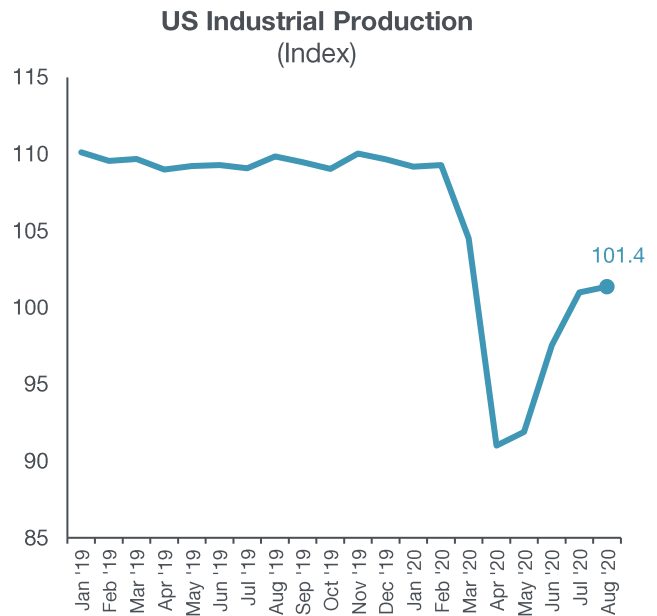
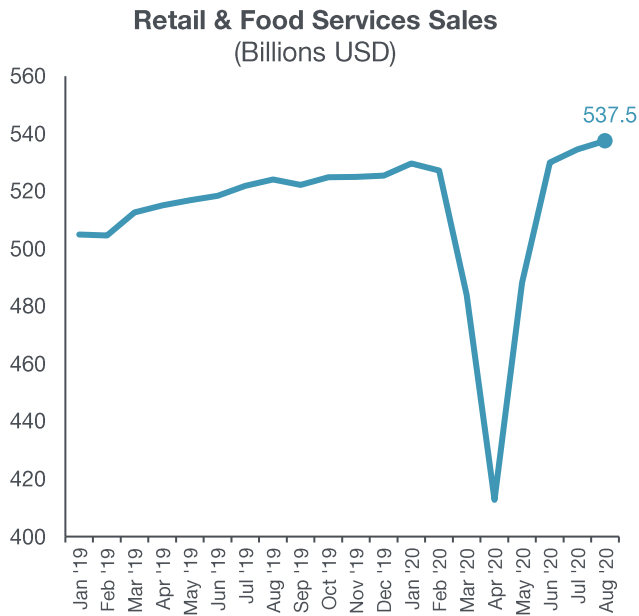
In the past, most deferrals would have been labeled troubled debt restructurings (TDRs) and made akin to nonperforming assets. Due to the nature of what caused deferrals they have not been characterized as such. Nonetheless, a 2-3% deferral level, if considered nonperforming, would not be that dramatic. However they be characterized, in many instances their level is low enough to suggest inherent losses may no longer be extreme, such as were suggested in the last DFAST projections. Bank CEOs report virtually no surge in charge offs surfacing now and most have stated the bulk of their reserve building is likely behind them. This is increasingly credible, although we will have to wait to see how the level of charge offs looks later this year and into next.

There are other macroeconomic reasons for optimism. For example, retail unemployment is recovering faster than we would have expected. Unexpectedly, retail sector jobs grew 249,000 during August, the largest movement in the Bureau of Labor Statistics report, excluding government (which included 238,000 Census temporary employees). Retail employment was cumulatively up 1.7 million since the bottom and is essentially 73% recovered from its February base! This is somewhat counterintuitive but the likes of Amazon and Walmart hiring could be considered a major, offsetting factor. Even the hardest hit Leisure and Hospitality category is up 4.1 million, which was halfway back to February levels.

Additionally, the U.S. macroeconomic numbers were strong again in August although moderating as we expected, making it look like the “V” is over and the “U” is taking over. It is fair to say the economic rebound was greater than we had expected but that it is ending sooner than we thought.

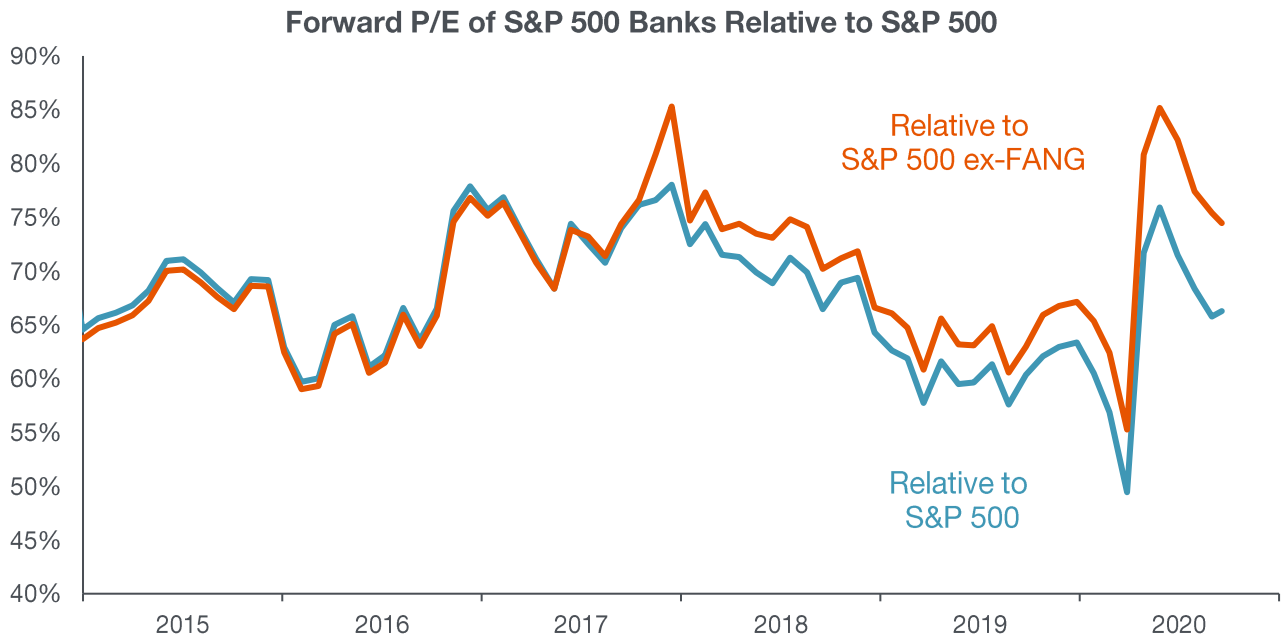
Retail spending (which excludes most services) and industrial production are shown monthly below. Retail’s recovery is promising but the expectation is that it will soften going forward.

Industrial production paints a different picture, halting well before its pre-COVID level and slowing considerably. Overall it is unlikely to assume the recent rebound can continue at its pace off the bottom. Our view is that it will grow but at a far more moderate pace, and perhaps with a pause pending an infection revival and/or the lack of further stimulus.



Source: U.S. Census Bureau, Federal Reserve

In sum, three of the four hurdles and their surrounding uncertainty on bank performance remain: Depressed margins, lack of loan demand and the outcome of the election. However, these factors have to be partially reflected by depressed valuations and stock price performance in our view. The fourth, and we think the more onerous risk, a super-sized loss cycle, appears hopefully less likely. Relative price/earnings to either the S&P 500 or the same excluding the FANG stocks bottomed at a 20+ year low and have only partially recovered.



Source: Bloomberg

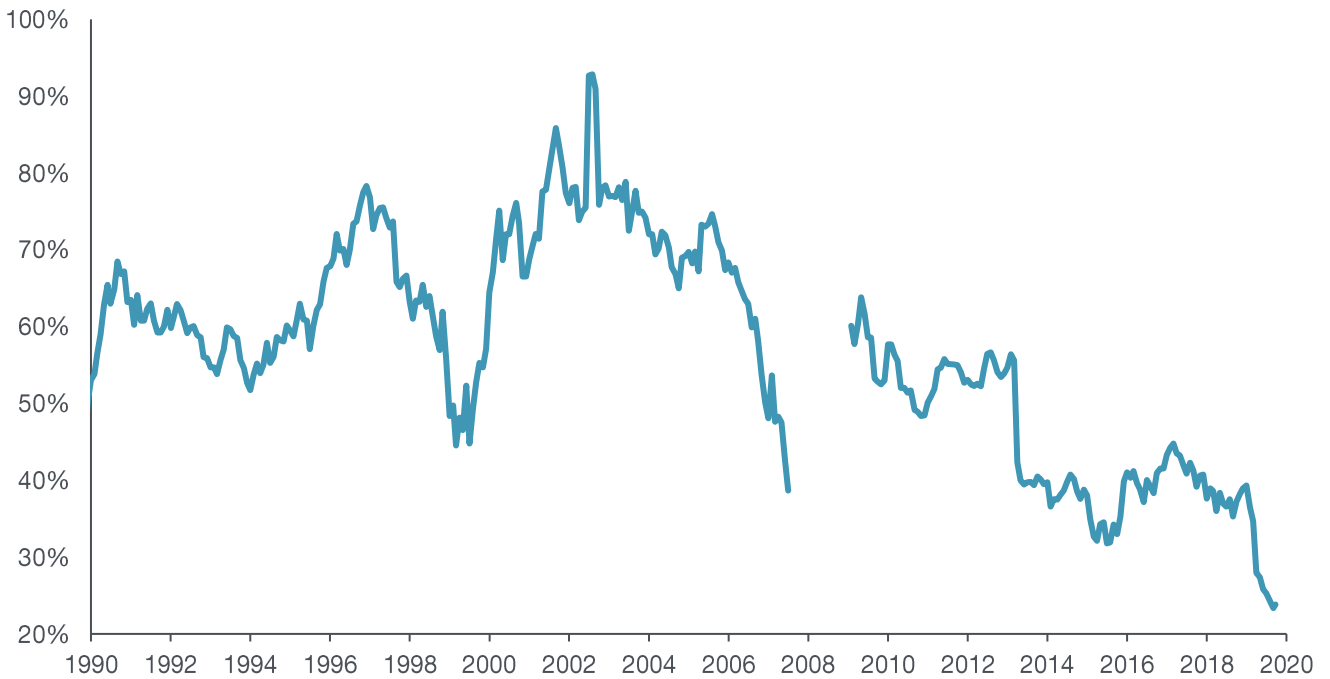
Price/earnings ratios are distorted when earnings become aberrantly weak and price/book ratios become more useful. As seen in last graph below, relative price/book is clearly at a new low point. A compelling argument for undervaluation.

**Forward P/E of S&P 500 Banks Relative to S&P 500**



Source: Bloomberg

**Price to Book of S&P 500 Banks Relative to S&P 500**



Source: Bloomberg

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